TEACHERS' RETIREMENT BOARD

INVESTMENT COMMITTEE

SUBJECT: Alternative Investments – Policy Review

ITEM NUMBER: 6

ATTACHMENTS: 2

ACTION: X

DATE OF MEETING: March 6, 2002

INFORMATION:

PRESENTER(S): Réal Desrochers

Background:

At the Investment Committee meeting on February 6, 2002, the Committee discussed the current investment opportunity, cited by the State Controller, in the distressed debt market. The Committee directed Staff and the Committee's Alternative Investments Consultant, Pathway Capital, to review the Policy and recommend any changes required to take advantage of this opportunity. The Alternative Investment Policy is enclosed as Attachment 1.

Recommendation:

Both Staff and Pathway concur with the State Controller's recognition of a unique market opportunity, and both parties are currently working on commitments to the area. After a thorough review of the Policy, Pathway Capital recommends that no change is required to the current Policy. Pathway's letter is enclosed as attachment #2. Staff concurs with this finding and notes that the Policy is flexible enough to allow the Fund to make a sizable investment to seize the current market conditions.

Prepared on February 19, 2002 by:

Réal Desrochers

Director of Alternative Investments

Review & Concur:

Christopher Ailman
Chief Investment Officer

CalSTRS

CALIFORNIA STATE TEACHERS' RETIREMENT SYSTEM

ALTERNATIVE INVESTMENTS Policies

INVESTMENT BRANCH July 2001

INTRODUCTION

In accordance with the Investment Management Plan, California State Teachers' Retirement System (CalSTRS) has a commitment to illiquid equity and equity related funds actively managed by specialized professionals to achieve a total rate of return superior to public equity vehicles.

The portfolio holding these assets is identified as Alternative Investments. This portfolio can include limited partnerships, direct investments, co-investments, and secondary interests in the following market segments:

- Leveraged Buyout
- Venture Capital
- Distressed Debt
- Mezzanine Financing
- Natural Resources

The primary objective for the alternative investment portfolio is to provide enhanced investment returns over those available in the public market. The increased risk associated with the structure, liquidity, and leverage requires a higher net total rate of return.

The CalSTRS Board established the asset allocation and strategic objectives for the alternative investment portfolio. The management of all types of investments is performed by internal and external professionals which are monitored and evaluated by internal investment officers and an external alternative investment consultant. The internal investment officers operate under the direction of the Chief Investment Officer or designee. The external alternative investment consultant reports directly to the CalSTRS Board.

This manual will establish the policies and procedures involved in the management of investment of Alternative Investments. The policies are designed to set boundaries for expected performance, diversification, and investment structure. The procedures are designed to provide guidelines for the implementation of the approved policies. A flow chart is provided to establish context for the policies presented.

ALTERNATIVE INVESTMENT PROGRAM

The following represent the approved policies to be utilized in the management of the alternative investment segment of the total investment portfolio. The policies are designed to set boundaries for the expected performance and structure. Policies approved by the CalSTRS Board cannot be altered without explicit direction from the CalSTRS Board.

- 1. The alternative investment portfolio of the California State Teachers' Retirement System is invested in a prudent manner for the sole benefit of CalSTRS participants and beneficiaries in accordance with the Teachers' Retirement Law and other applicable statutes.
- 2. The alternative investment portfolio shall be invested to provide enhanced investment returns. Generating high rates of return shall always be the primary objective with diversification being an ancillary benefit. The alternative investment portfolio performance benchmark shall be the dollar weighted return for the Russell 3000 Index plus 5% adjusted for the latest three years contributions at the 3-month T-bill return.
- 3. Diversification within the alternative investment portfolio is critical to control risk and maximize returns. The specific investments shall be aggregated, evaluated, and monitored to control unintended biases. Diversification can occur across the following parameters.
 - A. **Market Segment** -- The market segments are defined as Leveraged Buyout, Venture Capital, Distressed Debt, Mezzanine Financing, and Natural Resources.
 - B. **Vintage Group** -- Vintage group is defined by the closing date of the limited partnership. Investments within market segments shall be stratified by vintage group to mitigate the impact of fund flow trends within each segment.
 - C. **Economic Sector** -- Economic sectors are described by the standard Value-Line categories such as finance, technology, medical health, or electronic.
 - D. **Geographic Location** -- Geographic regions are defined as the location of the head office of the company. The geographic breakdown is expressed as West Coast, Southwest/Rockies, Southeast, Northeast, Mid-West, Mid-Atlantic, United Kingdom, Europe, and Canada.

Investments shall not be approved for the sole purpose of aligning one specific diversification range. Projected rate of return, risk, and other policies shall receive consideration in addition to diversification.

- 4. A strategic target and range shall be established for the market segment criteria. The target and range may change over time as conditions warrant as approved by the Investment Committee. The target and range criteria are included as Exhibit 1. The diversification criteria will be reviewed on an annual basis.
- 5. No investment vehicle or activity prohibited by the Investment Resolution adopted by the Board in 1984, as amended from time to time, will be authorized for the alternative investment portfolio.
- 6. Authorization letters which indicate who may sign on behalf of CalSTRS shall be included at the time of closing. Whenever a change in authorized signers take place, the limited partnerships shall be notified in writing within 24 hours in the event of termination and as soon as possible in the event of a newly authorized signer(s).
- 7. Prior to being processed by the Operations Area, all cash contribution and stock sales transaction tickets shall be signed by two Investment Officers.
- 8. Graduated limitations of daily trading authority for aggregate alternative investment portfolio transactions are as follows:

Associate Investment Officer	\$	1 million
Investment Officer I	\$	5 million
Investment Officer II	\$	10 million
Investment Officer III	\$	20 million
Principal Investment Officer	\$	35 million
Director of Alternative Investments	\$	50 million
Chief Investment Officer	\$2	00 million

- 9. The alternative investment portfolio will be managed according to an annual business plan whose main business components will encompass an analysis of the investment environment, a review of the investment strategy, a review of the diversification targets, and a resource allocation budget.
- 10. The alternative investment consultant will prepare and present a portfolio management reports on a semi-annual basis. The management report will provide portfolio diversification, largest holdings, common holdings, partnership performance, co-investment holdings, and committed and funded status.
- 11. The rejection decision for limited partnerships, direct investments, co-investments, and secondary interests is delegated to staff with the stipulation that all investment opportunities receive equal opportunity and subject to the appropriate amount of due diligence as defined in the alternative investment procedures.

PARTNERSHIP INVESTMENTS

- 12. The approval decision under delegation as it relates to new limited partnerships, followon limited partnerships, shall be completed following a positive written recommendation by the alternative investment advisor and CalSTRS' staff. The investment analysis and due diligence will be conducted in the same manner as previously reviewed by the Investment Committee.
- 13. The approval decision for "follow-on limited partnerships" is delegated to staff considering the following stipulations:
 - A. Applicable only to limited partnerships sponsored by general partner(s) included in the CalSTRS' alternative investment portfolio.
 - B. Due diligence process shall be consistent and appropriate as defined in the alternative investment procedures.
 - C. Maximum amount of the commitment shall not exceed \$400 million or 20% of the total amount of the partnership capitalization, whichever is less.
 - D. A final report will be presented to the Investment Committee as soon as practical after the commitment is completed.
- 14. The approval decision for "new limited partnerships" is delegated to staff considering the following stipulations:
 - A. Due diligence process shall be consistent and appropriate as defined in the alternative investment procedures.
 - B. Maximum amount of the commitment shall not exceed \$100 million or 20% of the total amount of the partnership capitalization, whichever is less.
 - C. A final report will be presented to the Investment Committee as soon as practical after the commitment is completed.

SECONDARY PARTNERSHIPS

- 15. The approval decision under delegation as it relates to investing in limited partnerships that purchase secondary interests shall be completed following a positive written recommendation by CalSTRS' staff and either the alternative investment advisor or a project consultant. The approval decision under delegation as it relates to purchasing secondary interests shall be completed following a positive written recommendation by CalSTRS staff and either the alternative investment advisor or an independent fiduciary. The investment analysis and due diligence will be conducted in the same manner as previously reviewed by the Investment Committee.
- 16. The approval decision for "secondary limited partnership" interests is delegated to staff considering the following stipulations:
 - A. Due diligence process shall be consistent and appropriate as defined in the alternative investment procedures.
 - B. Maximum amount of the commitment shall not exceed \$100 million or 20% of the total amount of the partnership capitalization, whichever is less.
 - C. A final report will be presented to the Investment Committee as soon as practical after the commitment is completed.
 - D. Secondary partnership investments may be made in partnerships in which CalSTRS is not a limited partner.

CO-INVESTMENTS

- 17. The approval decision under delegation as it relates to co-investments shall be completed following a positive written recommendation by the CalSTRS staff and either 1) an alternative investment advisor, or 2) an independent fiduciary. The investment analysis and due diligence will be conducted by the CalSTRS staff (as identified in the Alternative Investment Procedures) and by the above external entity. CalSTRS staff and the above external entity must each provide a positive written recommendation.
- 18. The approval decision for co-investments is delegated to staff considering the following stipulations:
 - A. Co-investments shall be made on the same (or better) terms and conditions as provided to the partnership.
 - B. Due diligence process shall be consistent and appropriate as defined in the alternative investment procedures.
 - C. Maximum amount of each commitment shall not exceed \$75 million or 30% of the CalSTRS commitment to that partnership, whichever is less.
 - D. A final report will be presented to the Investment Committee as soon as practical after the commitment is completed.
 - E. Co-investments are limited to the United States, Canada, the United Kingdom, and Continental Europe. (The business activities of the co-investment must be primarily in these countries).
 - F. A co-investment may take the form of equity, convertible preferred equity or a comparable instrument which provides an equity type of return.

March 3, 1999 alternative investment presentation to the Investment Committee, in addition to Alternative Investment procedures, glossary of terms, and desk manual, are incorporated into this policy by reference.

Adopted June 1998 Revised July 1998 Revised April 1999 Revised April 2001 Revised July 2001

Exhibit 1

Alternative Investments Subcategory	Approved Ranges	Approved Targets
Buy-out	45-65%	55
Venture capital	10-30%	20%
Debt related	0-5%	0%
Equity expansion	5-15%	10%
International (Canada, United Kingdom, Continental Europe)	10-25%	15%
Total		100%

GLOSSARY

ACQUISITIONS - See Leveraged Buyouts.

ACQUISITIONS – ADD ON - Add-on acquisitions, or platform investing, is a growth strategy, which involves the acquisition of a company that will be the base (or platform) from which future acquisitions will be made. This strategy invests in consolidating industries by teaming with key industry management to build companies through acquisition and internal growth. Initially, an industry with an unrecognized market niche, high growth potential and no clear market leader is identified. If a suitable company can not be identified, the investment manager may recruit a management team to run the new business. The company's management and the investment manager, acting as a team, will identify and negotiate to buy additional companies within the target industry. A "critical mass" is achieved when the investment manager consolidates formerly entrepreneurial-managed, fragmented operating units into a single portfolio company with standard operating procedures. As a result, the larger company becomes visible and attractive to a wider group of potential buyers. Other companies in the market typically are willing to pay a higher price earnings multiple to buy the portfolio company than paid by the investment manager for its component parts.

ADVISORY BOARD - Advisory Boards play a role in the governance issues relating to the fundamental aspects of the fund, such as decisions on valuations and management conflicts of interests. Generally, a majority of the composition of the Advisory Board is comprised of the largest limited partners in the limited partnership.

AGGREGATION OF PROFITS AND LOSSES - Aggregation of profit and losses ensures a fairer profit sharing between the general partner and the limited partners. This calculation is based on the entire performance of the portfolio rather than on a deal by deal basis.

BUYOUTS - See Leveraged Buyouts.

CARRIED INTEREST - The mechanism by which general partners are compensated for their performance. The general partner's carried interest is its share of the partnership's profits, and generally ranges from 10% to 30% of the total. A 20% carried interest has become the industry norm.

CO-INVESTMENTS - Privately negotiated purchase of equity or quasi-equity from private or publicly traded entities. Such investments involve the purchase of non-registered securities, which by their private, illiquid nature command a premium over comparable publicly traded securities. These will not be stand-alone investments and will always be made alongside a partnership investment on pari-passu, or better terms, than the partnership is making its direct investment.

CONVERTIBLE PREFERRED STOCK - A class of stock having different rights than Common Stock, including a liquidation preference over Common Stock; and allowing the Preferred Shareholder to convert Preferred shares into Common shares at some specified conversion ratio. Conversion typically occurs in conjunction with and initial public offering, providing a means of liquidation for the Preferred Shareholder.

DIRECT INVESTMENTS - Direct Investments are similar to co-investments in that the investment is made outside of a limited partnership structure, and made directly into the target company. However, direct investments differ from co-investments in that they are not made alongside an existing partnership. Direct investments require a greater level of due diligence, a greater amount of time to pursue and perform due diligence, and they also involve a greater level of risk in comparison to co-investments.

DEBT RELATED INVESTMENT STRATEGIES - Debt related investments include subordinated debt and distressed debt investment strategies. Subordinated debt is often used to help finance leveraged buyouts or other similar transactions. Subordinated debt typically takes the form of mezzanine securities, junk bonds, convertible preferred stock, and other high yielding debt oriented securities. Although considered debt-oriented, securities at the subordinated debt or mezzanine level typically possess equity conversion features, rights, and warrants. Investors at the subordinated debt level are junior to the senior debt holders in a leveraged buyout transaction, meaning they receive interest payments after the senior debt has been satisfied and they share in a liquidation after the senior paper holders have made their claims. However, subordinated debt suppliers are senior to the common equity holders of the company.

Distressed debt investments are a form of recovery investing that focus on the debt of a distressed company. Distressed debt investing is defined as the investment in debt securities (generally senior-secured debt) of troubled or bankrupt companies. Also see Restructuring/Recovery investments.

DISTRESSED DEBT - See Debt Related Investment Strategies

DISTRIBUTIONS - Cash and/or securities paid out to the limited partners from the limited partnership.

EQUITY EXPANSION - Equity expansion investments involve the purchase of substantial, long-term minority equity positions in undervalued, privately or publicly held companies. This strategy is similar in style to later stage venture capital investments, except that equity expansion investments are generally larger, and are typically less technology oriented. These small and medium sized companies have grown from the start-up stage to profitability and are poised for continued rapid growth.

FIRST TIME LIMITED PARTNERSHIPS - All funds not identified as follow-on.

FOLLOW-ON LIMITED PARTNERSHIPS - The second and all subsequent funds raised by a management team that are included in STRS' portfolio and rated as Tier 1 or Tier 2. Funds formed by a management team that had substantial changes in the investment team and/or their investment strategy and/or scope of their business from domestic to international will not be classified under this category.

GENERAL PARTNER - Managing partner of a limited partnership responsible for performing the day-to-day administrative operations of the partnership and acting as investment advisor to the partnership. The general partner typically invests 1% of the capital and retains 20% of the profits.

HURDLE RATE - A rate of return that must be met before the General Partner can share in the carried interest.

INITIAL PUBLIC OFFERING "IPO" - The sale or distribution of a stock or a portfolio company to the public for the first time.

INTERNAL RATE OF RETURN "IRR" - The discount rate at which the present value of future cash flows of an investment equals the cost of the investment. It is determined when the net present value of the cash outflows (the cost of the investment) and the cash inflows (returns on the investment) equal zero, the rate of discount being used is the IRR.

INTERNATIONAL BUYOUT - An international buyout fund is a limited partnership that generally focuses on acquisition, equity expansion, or later stage investment strategies, however, the fund's primary geographic focus is outside of the United States.

J-CURVE - The J-Curve phenomenon is the effect of the cash flow behavior of a partnership. It can be summarized as the first year's investment expenses of investing in a fund that has yet to harvest its capital gains in the future. This normally translates into a negative IRR in the early years of the fund. The plot of the partnership values versus time, generally resembles a "J."

JUST IN TIME CAPITAL CALL - The practice is to take capital calls as needed on a transaction per transaction basis.

KEY MAN PROVISION - Limited partners are demanding the right to suspend the funding of the partnership if some of the key people were to leave the firm. This provision is designed to assure the continuity of the firm, and to assure that success (if related to various individuals) stays within the firm.

LEVERAGED BUYOUTS (ACQUISITIONS) - Acquisitions involve the purchase of all or part of the stock or assets of a company utilizing a significant amount of borrowed capital and a relatively small portion of equity capital. Borrowed capital typically consists of some combination of senior and subordinated debt. The company may be privately or publicly owned, or a subsidiary or division of a privately or publicly owned company. Acquisitions generally include companies with stable cash flows, high market share, and high profit margins, selling low or non-technology products in industries not subject to wide profitability swings.

The general goal behind an acquisition investment is to acquire a company, division or subsidiary that is currently undervalued, and whose assets may be underutilized, and restructure and revitalize it. Ideally, the revitalized company can then be sold, recapitalized, or taken public at a substantial premium to its pre-buyout value.

LIMITED PARTNER - The investors in a limited partnership, generally providing 99% of the capital and receiving 80% of the profits. Limited partners do not participate in the management of the partnership's activities. However, they normally have the right to vote to approve or disapprove amendments made to the limited partnership agreement.

LIMITED PARTNERSHIPS - Organization made up of a General Partner, who manages the operations, and limited partners, who invest capital but have limited liability. Limited partners are not involved in the day-to-day management of the partnership and generally cannot lose more than their capital contribution.

LOOKBACK PROVISION - The lookback guarantees that the stated profit allocation is met at the end of the partnership's term with respect to the limited partners.

MANAGEMENT FEES - The management fee is designed to compensate the general partner. This fee is used to provide the partnership with such resources as investment and clerical personnel, office space, and administrative services required by the partnership. Generally, the fee ranges from 1.5% to 3.0% of capital commitments.

MEZZANINE (ALSO SEE SUBORDINATED DEBT) - Mezzanine investments are in unsecured or junior obligations in financing. They typically earn a current coupon or dividend and have warrants on common stocks or conversion features to enhance returns.

MULTIPLE OF MONEY - Multiple of money is often used to measure performance. This is a cumulative return, identifying the return on an investment over the term of the partnership. A multiple that is greater than one indicates that the partnership's total value exceeds the amount of capital contributed to date, whereas, a multiple less than one indicates that the partnership's total value is less than the amount of capital contributed. In summary, achieving a high annualized rate of return over a long period of time is more impressive than achieving a high annualized rate of return over a shorter period of time.

NATURAL RESOURCES - These investments utilize investment strategies that derive their return from the management of and the independent price movements in a particular resource. These investments are more specialized with a corresponding increase in risk. Sub-categories of this group include <u>Oil and Gas</u> – provides funding for the purchase or development of energy producing properties or companies operating within that sector, and <u>Timberland/Farmland</u> – provides funding for the purchase, development and/or lease of land for both growth and incomeoriented strategies.

NEW LIMITED PARTNERSHIPS - All funds not identified as Follow-On.

OIL AND GAS - See Natural Resources

PARTICIPANTS - Three major participants in the private equity market are investors (suppliers of capital), issuers (users of capital) and specialized intermediaries. These three participants are further defined below:

INVESTORS – include a variety of groups such as public and corporate pension funds, endowments, and foundations, bank holding companies, insurance companies, and wealthy families. Currently, public and corporate pension plans are the largest source of private equity.

ISSUERS – includes thousands of start-up businesses that are established annually. In addition, some estimates suggest there are approximately 120,000 private companies in the United States with revenues greater than \$10 million, representing a market far greater than the 10,000 to 15,000 publicly traded companies.

SPECIALIZED INTERMEDIARIES – invest as principals rather than as agents, and generally take the form of limited partnerships. Institutional investors acquire limited partnership interests and become limited partners, while professional private equity managers serve as general partners. Although some institutional investors directly acquire private equity securities, 80% of all private equity investments are managed via the limited partnership vehicle. By investing through the limited partnership vehicle, rather than directly in issuing companies, investors achieve extensive diversification and employ the specialized talents of the general partners. The general partner provides the labor-intensive responsibilities of evaluating, conducting due diligence, negotiating, monitoring, and adding value, and eventually liquidating the private equity investments.

PARTNERSHIP EXPENSES - Expenses borne by the partnership including costs associated with the organization of the partnership, the purchase, holding or sale of securities, and legal and auditing expenses.

PARTNERSHIP TERM - The term of the partnership is normally ten years, with the general partner reserving the right to terminate the partnership early or extend the term for a set period of time. This is generally subject to the approval by the limited partners.

PORTFOLIO COMPANIES - Portfolio companies are any of the companies in which the private equity partnerships have an investment.

RESTRUCTURING/RECOVERY - Recovery investments involve the investment of capital in companies experiencing anywhere from relatively minor, to extreme difficulties, to companies involved in bankruptcy proceedings. Recovery investing takes advantage of discounted securities of unhealthy, bankrupt (or near); under-performing, and/or under-capitalized companies and either ride or steer them back to recovery. To accomplish this goal, the various funds available use a variety of strategies. The strategies vary by the activity level and/or degree of control required by the acquirers, types of securities utilized, and the relative health of the target companies sought (from bankrupt to nearly healthy). Also, like LBO and venture capital managers, managers of ailing company funds each have a particular target company size preference, and some have industry or sector preferences.

Distressed debt investments are a form of recovery investing that focus on the debt of a distressed company. Distressed debt investing is defined as the investment in debt securities (generally senior-secured debt) of troubled or bankrupt companies.

SECONDARY LIMITED PARTNERSHIP INTERESTS - Privately negotiated purchase of limited partnership interests or investment company interest. Such investments involve the purchase of a pro-rata ownership of non-registered securities, which are currently in, or will be a future purchase of, the partnership portfolio.

SPECIAL EQUITY - See all non-venture capital related investment strategies, such as Leveraged Buyouts, Acquisitions, Special Situations, Mezzanine Investments, Subordinated Debt, Hedge Funds and Natural Resources.

SPECIAL SITUATIONS - Special Situation funds represents a "catchall" for non-traditional investments that do not fit either of the above groupings. These will include minority, but often control positions in public companies, "white knight" efforts to support management's to achieve long-term objectives, turnarounds and bankruptcy reorganizations, and other special situation profit opportunities. It is not the intention to invest in "unfriendly" business take-overs.

SUBORDINATED DEBT - See Debt Related investment strategies.

TIMBERLAND/FARMLAND - See Natural Resources

TRANSACTION FEE OFFSETS - Transaction fee offsets are designed to eliminate misplaced management fees and align the actions of the general partner whose aim is to generate high capital gains, and not to earn additional fees for the firm. The general provision is that the earned fee will reduce the limited partners' management fees.

VENTURE CAPITAL - Venture capital refers to investments in young, emerging growth companies in different stages of development. The stages of venture capital investing include the following:

SEED STAGE – an entrepreneur seeking capital to conduct research or finish a business plan;

EARLY STAGE – a company developing products and seeking capital to commence manufacturing;

LATE STAGE – a profitable or near-profitable high growth company seeking further expansion capital. The common theme underlying all venture capital investments is the high-growth nature of the industries in which the investee companies operate and the active role played by the investor to identify additional management expertise and provide general business advice.

VENTURE ECONOMICS

Venture Economics is the leading compiler and publisher of private equity investment data. Accordingly, Venture Economics compiles data from over 588 venture capital limited partnerships formed from 1969 to 2000, and over 215 buyout and mezzanine funds formed between 1976 and 2000. With this data, Venture Economics computes the internal rates of returns (IRRs) on a vintage year basis including pooled, upper, median, and lower quartile returns for each sub-category.

UPPER QUARTILE – The point at which 25% of all returns in a group are greater and 75% are lower.

MEDIAN QUARTILE – The mid-point of all returns, with half the sample less than or equal to the median, and half of the sample greater than or equal to the median.

LOWER QUARTILE – The point at which 75% of all returns in a group are greater and 25% are lower.

POOLED RETURNS – This is a composite of all median and upper quartile returns.

VINTAGE YEAR - The year of fund formation and its first takedown of capital. By placing a fund into a particular vintage year, the limited partner can compare the performance of a given fund with all other similar type funds formed in that particular vintage year. In addition, that vintage year return can then be compared to an industry benchmark which is provided by Venture Economics.

February 14, 2002

VIA E-MAIL AND FEDERAL EXPRESS

Mr. Réal Desrochers
Director of Alternative Investments
California State Teachers' Retirement System
P.O. Box 163749
Sacramento, CA 95816-3749

Dear Réal:

In consideration of CalSTRS' recent decision to commit \$350 million in distressed debt funds, Pathway Capital Management, LLC ("Pathway") has concluded that CalSTRS' existing Alternative Investments Business Plan ("Business Plan") accommodates the new mandate and no new unique measures are required.

CalSTRS' existing Business Plan is well drafted, thoughtful, clear and concise in its approach to alternative investment portfolio diversification. The Business Plan states that the debt segment of the portfolio will include subordinated debt and distressed debt fund investments.

Specifically, CalSTRS can invest up to 5% of the alternative investment portfolio [Fair Market Value ("FMV") + Unfunded Commitments ("Unfunded")] in debt-related managers. Currently, the FMV plus the Unfunded value of debt-related managers is approximately \$207 million, or 2.5% of the FMV and Unfunded value of the entire private equity portfolio.

Pathway has determined, based on expected growth of the pension fund and the private equity portfolio, the current 5% debt allocation should be adequate to accommodate the additional \$350 million anticipated for investment in distressed debt partnerships. Pathway believes CalSTRS can commit the full \$350 million pursuant to the existing investment strategy, provided there are enough quality distressed debt managers available in the market.

Sincerely,

Albert M. Clerc Managing Director